GLOBAL SOLUTIONS
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Is Bigger Really Better? Moral Hazard Issues in Expanding Financial Safety Nets

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Topics

Ten years after:

Where do we stand?

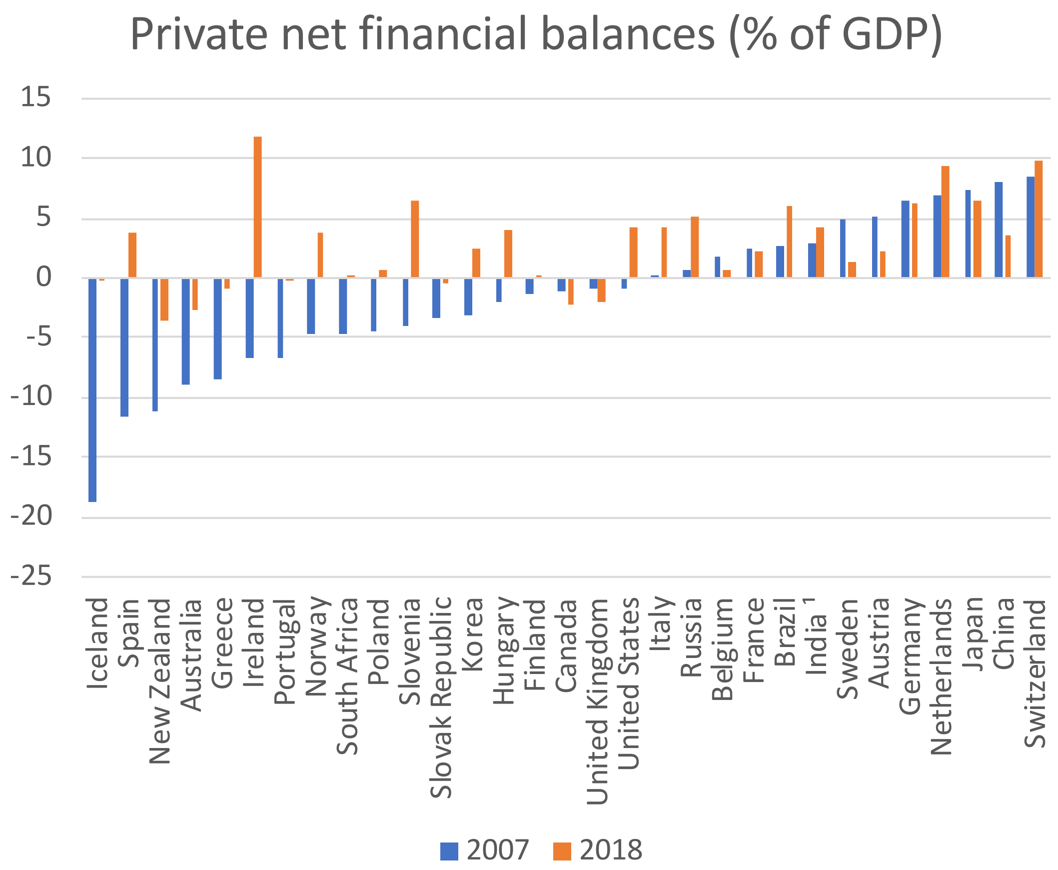
Small is beautiful:

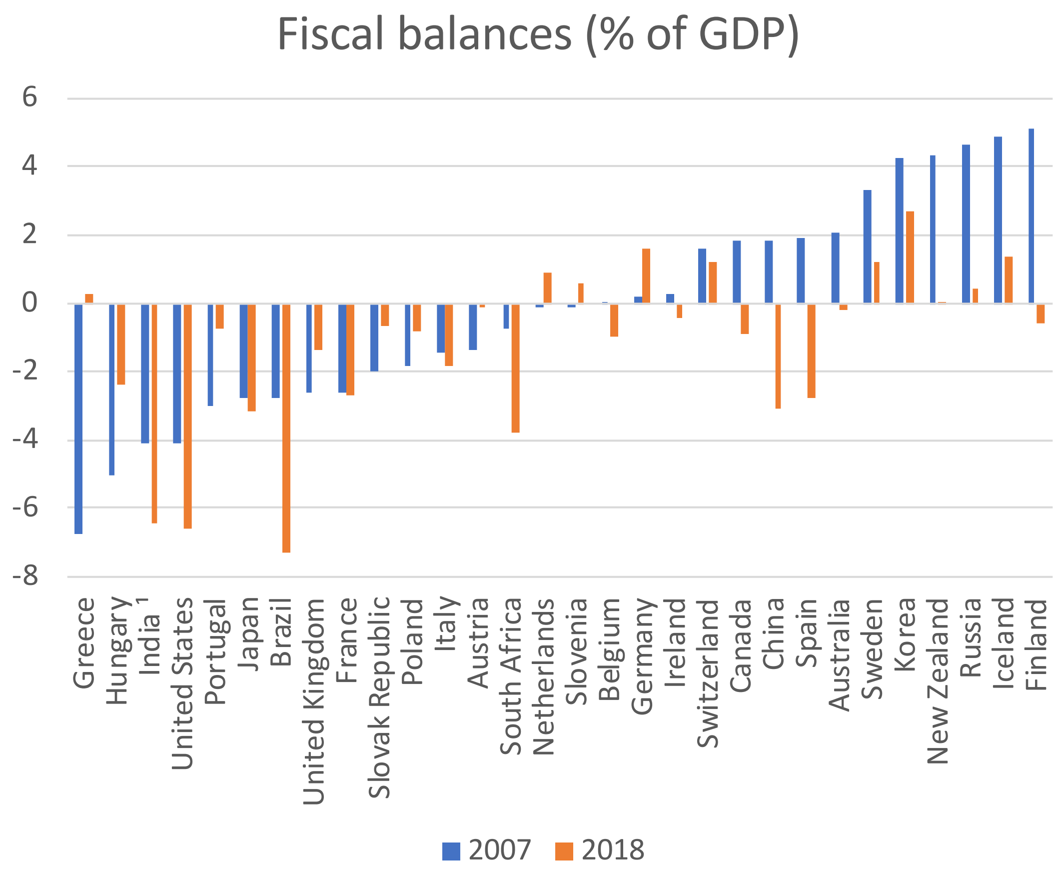
The German „Three Pillar System“

Moral hazard and safety nets:

Better inventives for bank managers

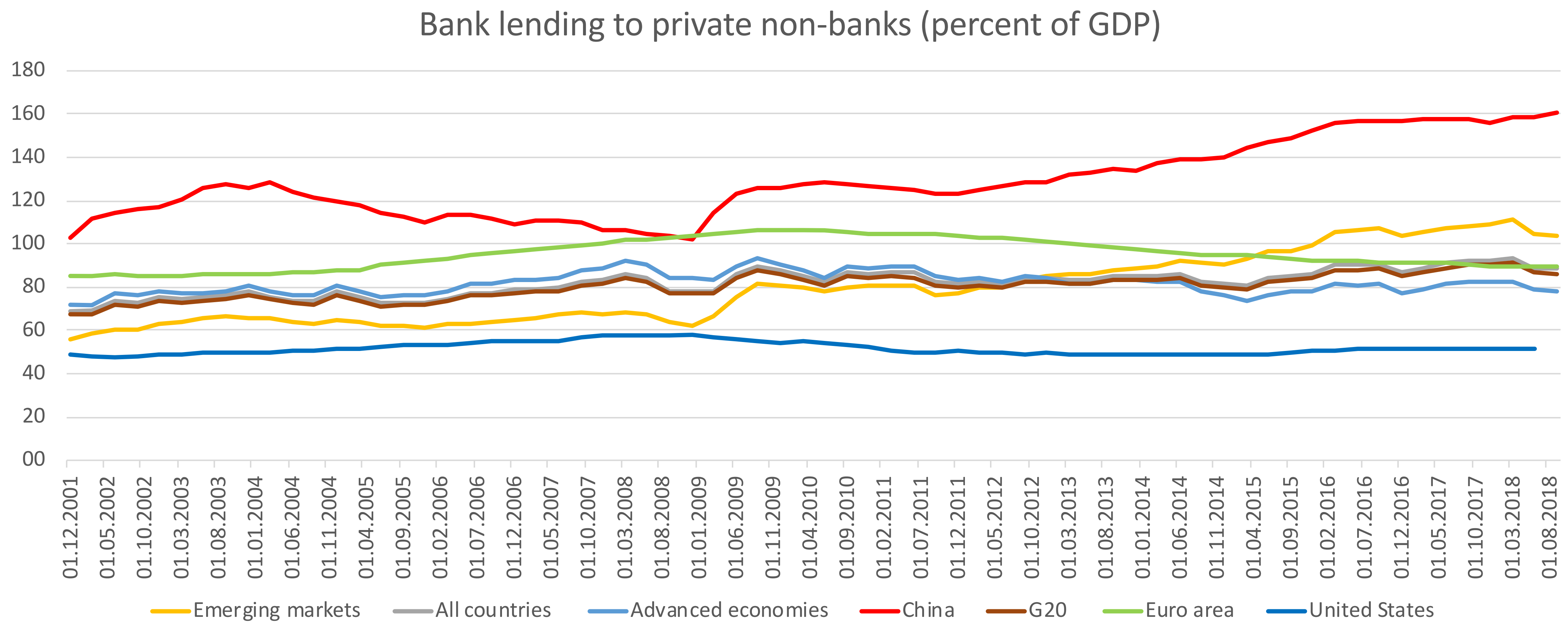
What has changed since 2007?
Private sector deleveraging, high public deficits





Private net financial balances = Current account minus Fiscal balance (Source: IMF)

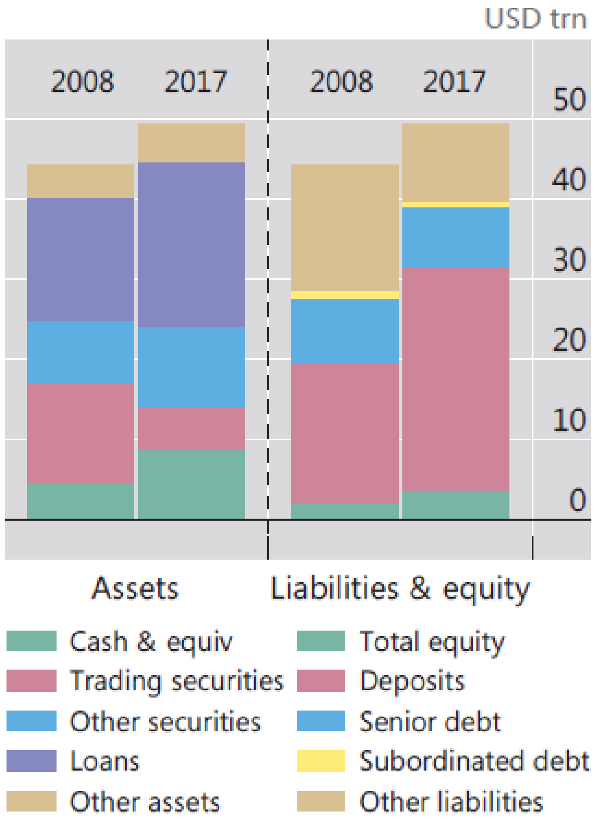
Bank lending stagnant with the exception of China



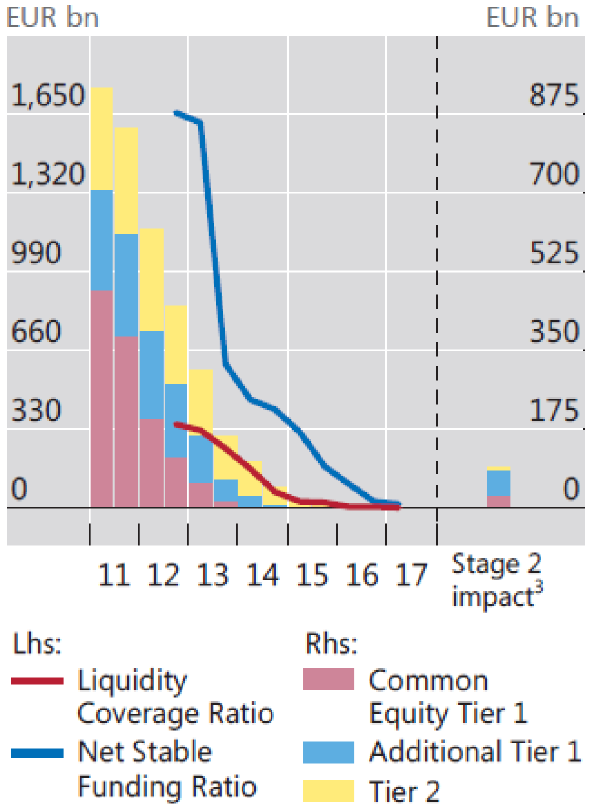
Source: BIS

Business models have become more conservative

G-SIB balance sheets reflecting changing business models[4]



Capital and liquidity shortfalls coming down[2]



2 The height of each bar shows the aggregated capital shortfall considering requirements for each tier (ie CET1, Additional Tier 1 and Tier 2) of capital for the major internationally active banks monitored by the BCBS (BCBS (2018)).

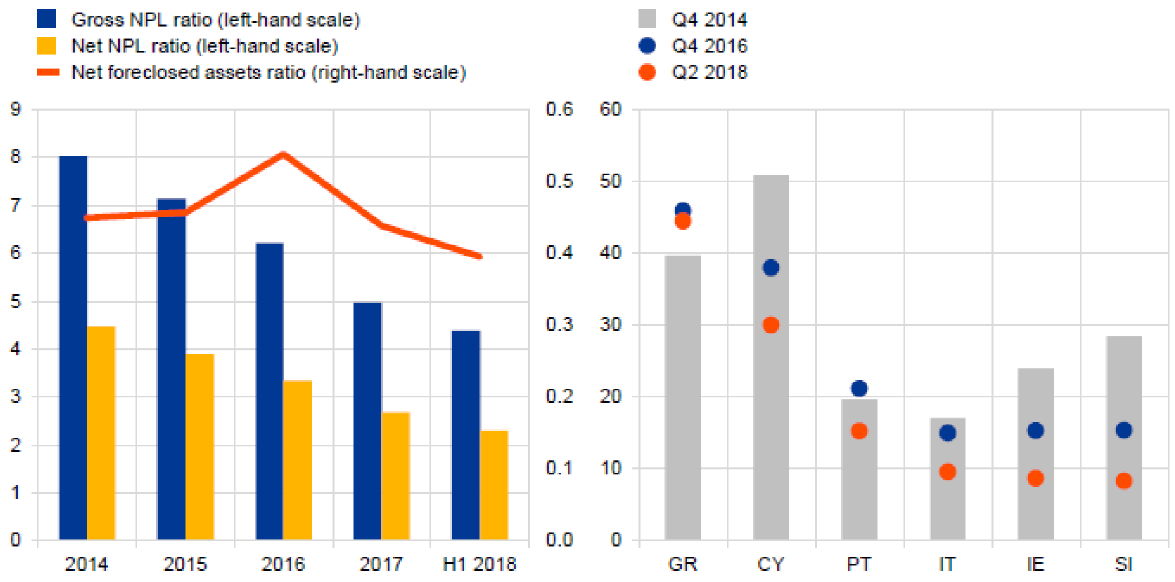
Source: BIS Annual Report 2018

NPL declining, but still high in Southern Europa

NPL reduction continued, but at varying paces across countries

Aggregate NPL and foreclosed assets ratios (left panel) and NPL ratios in high-NPL countries between 2014 and H1 2018 (right panel)

(2014-H1 2018, percentage of total loans)



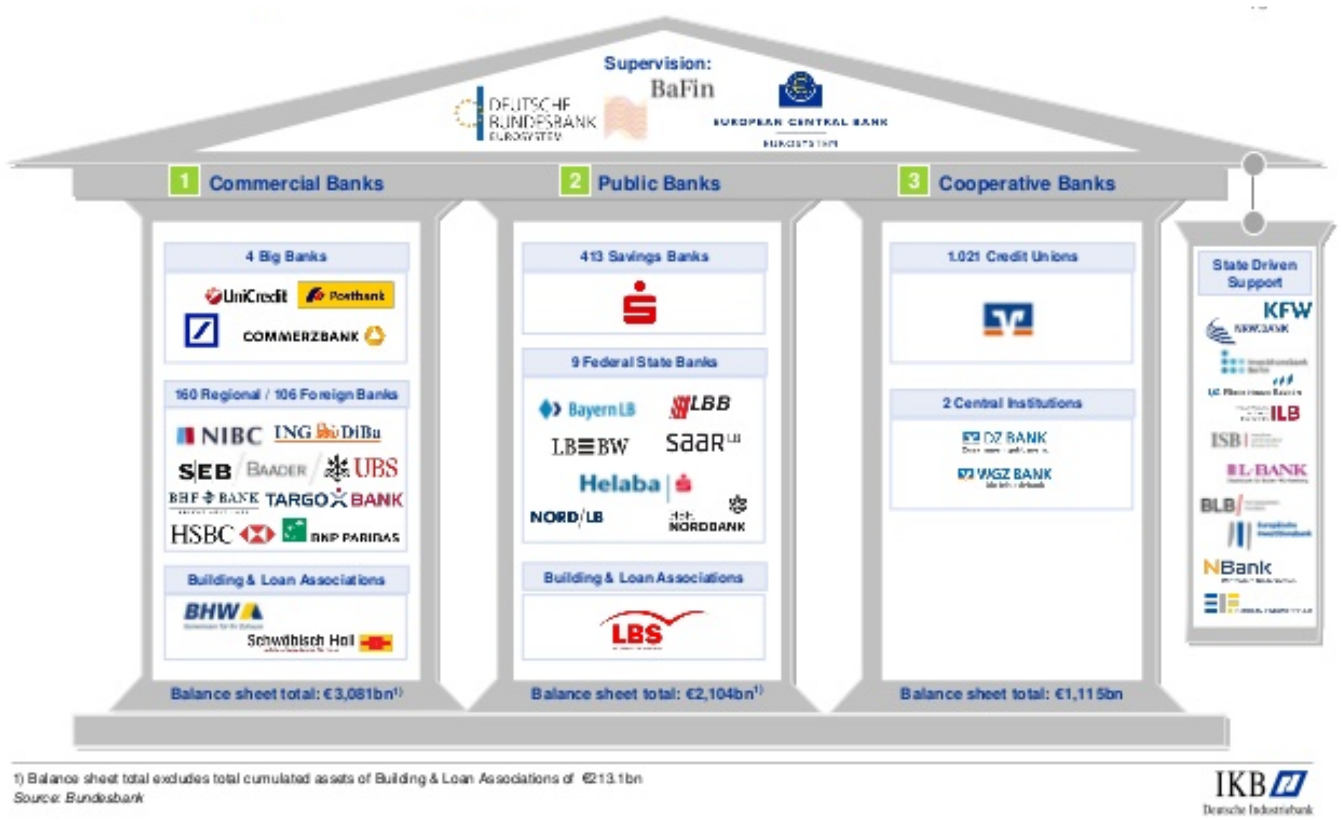
Source: ECB supervisory data.
Notes: In line with FINREP reporting on non-performing exposures, loans and advances also include cash balances at central banks and other demand deposits. Left panel: net NPLs and net foreclosed assets are calculated as gross NPLs/foreclosed assets less accumulated impairments. Right panel: based on country-level aggregates for significant institutions. Country-level NPL ratios refer to a balanced sample of significant institutions and are adjusted for mergers and acquisitions.

Source: ECB, Financial Stability Review November 2018

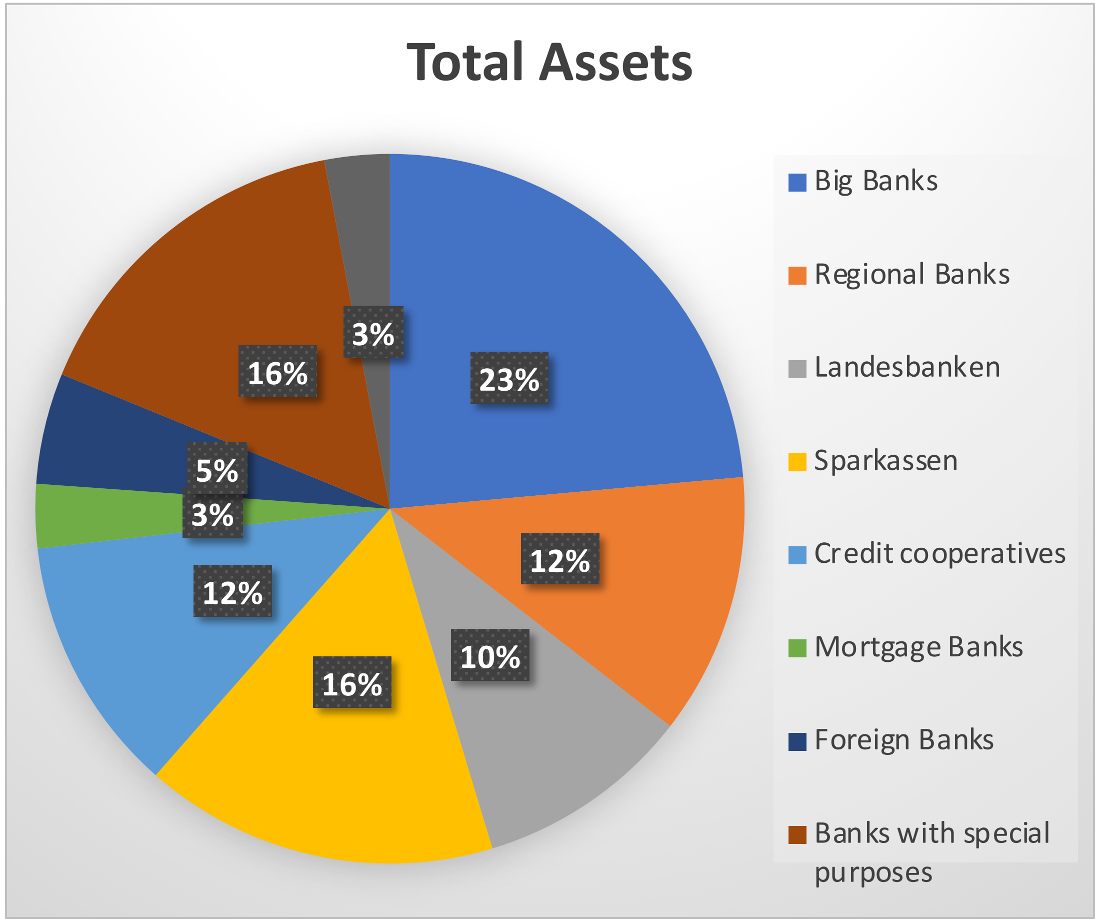
Expanding Safety Nets?

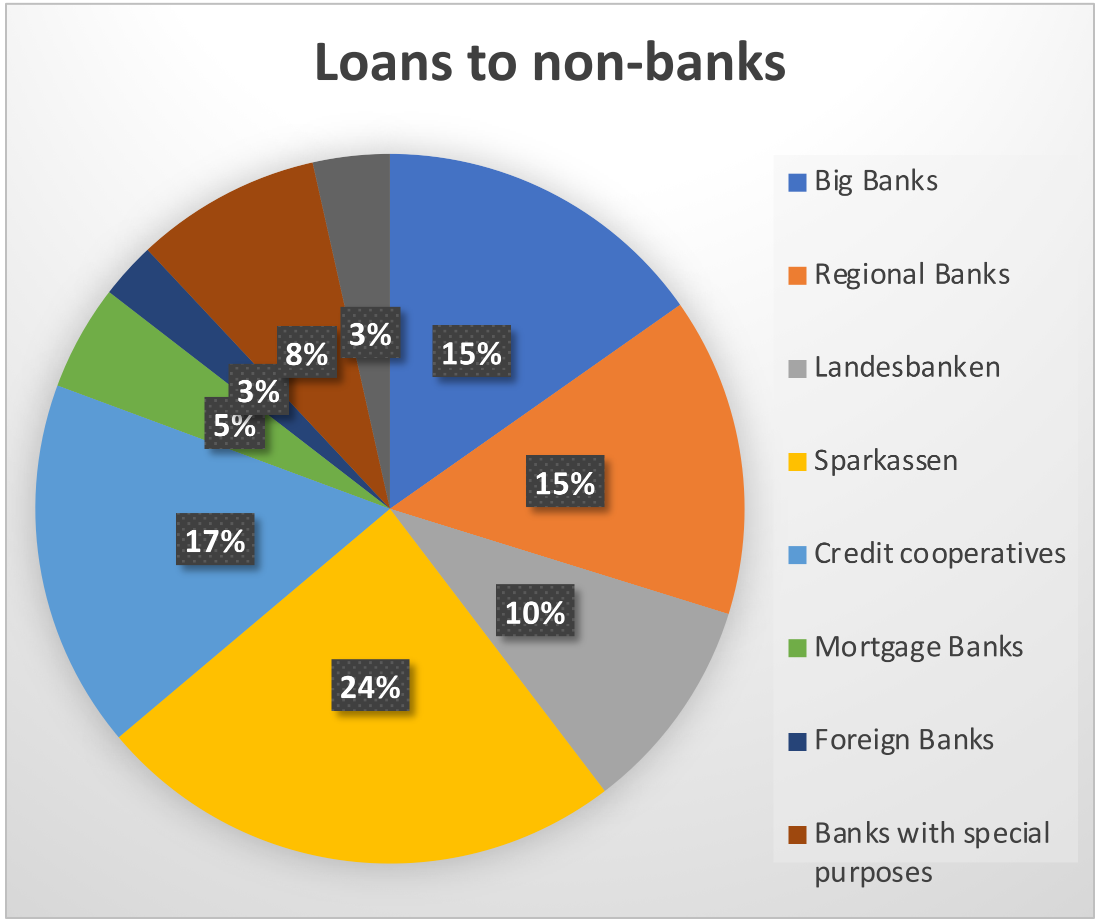
- Lender of Last Resort is already unlimited for countries indebted in their own currency
- Global dimension: Presentation by Helene Schuberth
- Considerable progress in extending the safety nets of the euro area:
    - ELA (Emergency liquidity) : Country specific lender of last resort
    - European Stability Mechanism (500 billion Euro): Lender of last resort for member state governments indebted in a „foreign currency“.
    - Single Resolution Mechanism (SRM), backed by Single Resolution Fund (SRF). ESM serves as backstop for SRF
    - Work in progress: European Deposit Insurance Scheme (EDIS) with a target size 0.8 percent of deposits is grossly overrated

Small is beautiful: Germany‘s „3 Pillar System“



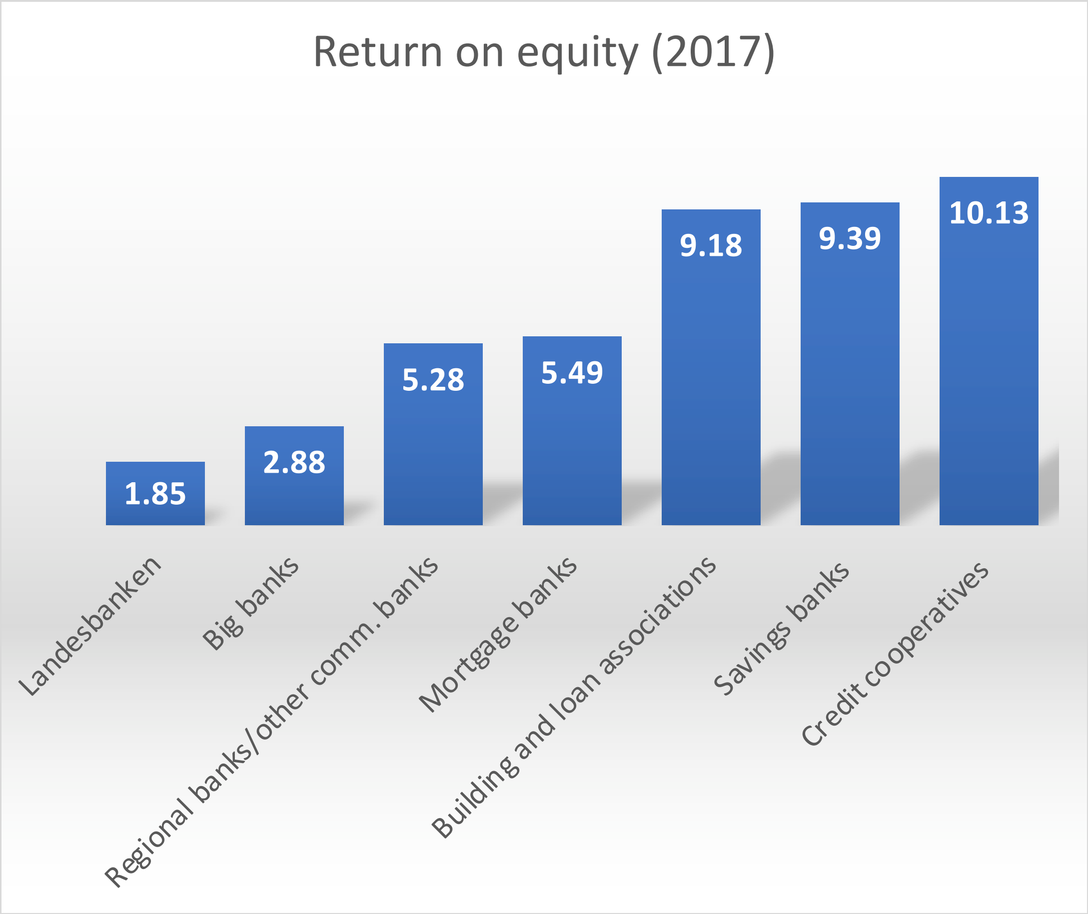
Is bigger better? The German „Three pillar system“





Source: Deutsche Bundesbank

Smaller is more profitable



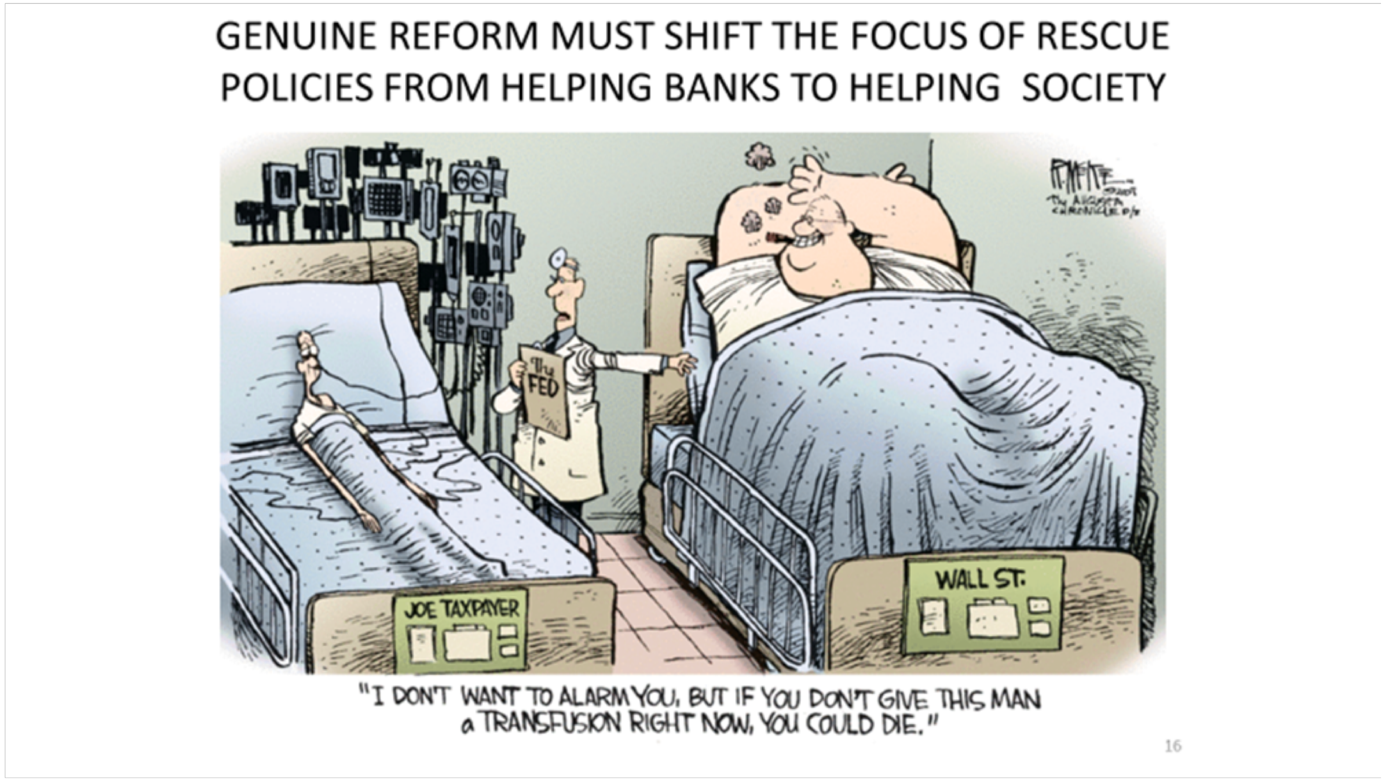
Advantages of the smaller banks

- Long-term orientation due to independence from capital markets
- Local anchoring combined with centralized service centers
- Support of social and cultural activities at the local level

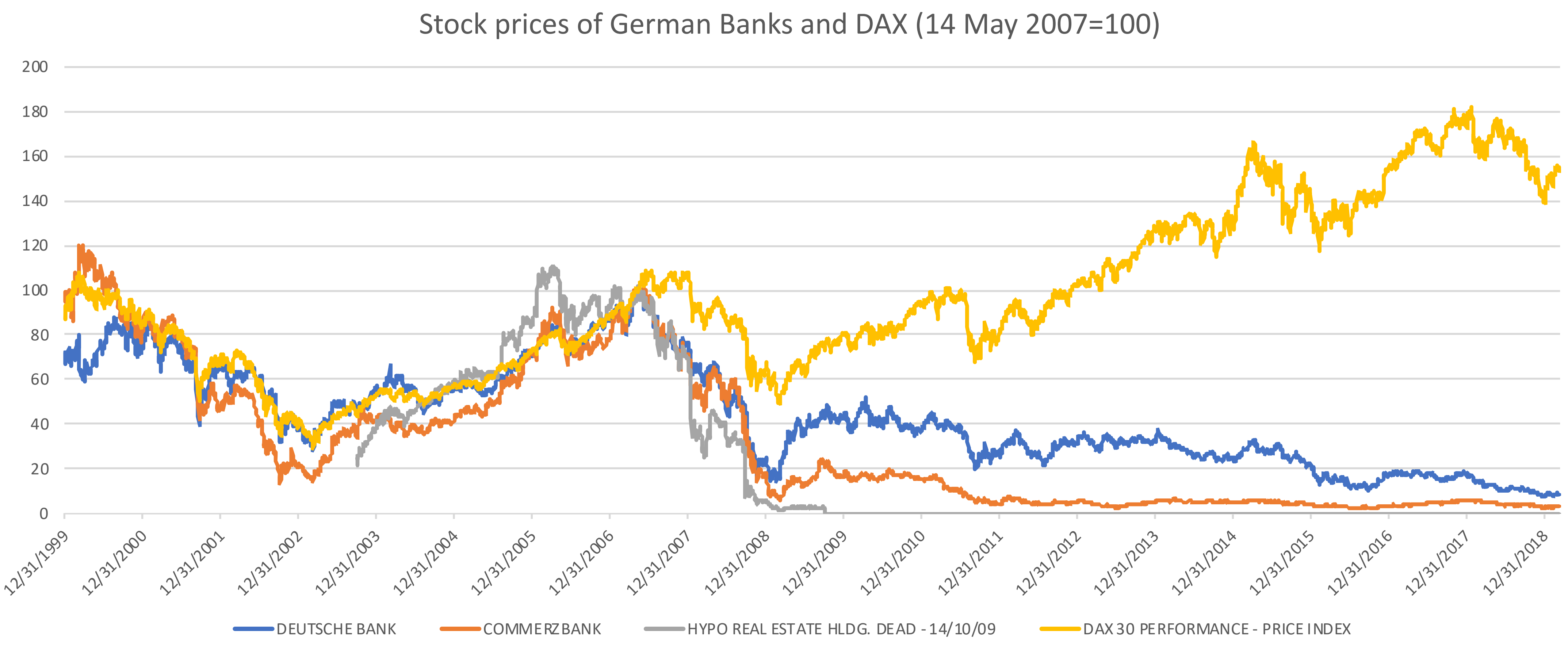
Who is saved by financial safety nets?

Source:

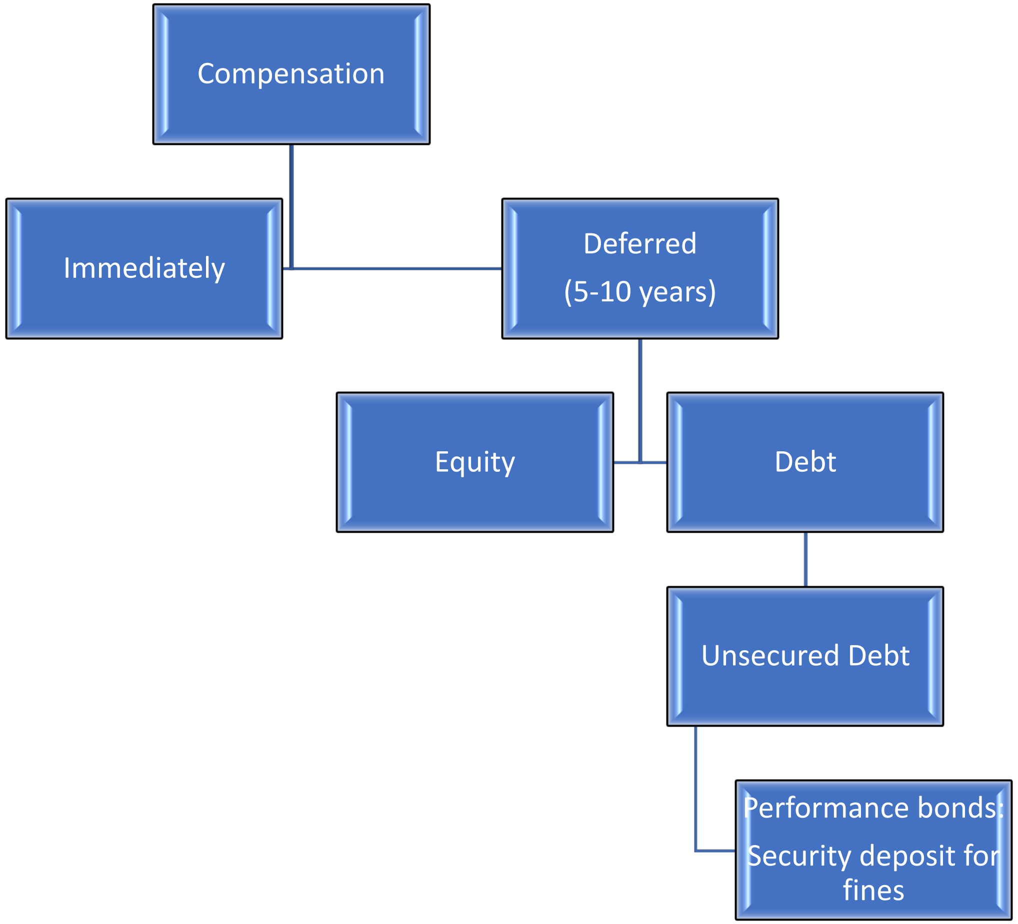
Presentation Edward J. Kane



Profits private, losses social?



Setting the right inventives for bank mangers (Dudley-Proposal)



Summary

The world has changed dramatically since 2007

- Net private lending has almost vanished (China is the exception)
- Bank business models have become more conservative
- No obvious need for expanding safety nets

The German experience: Diversified banking systems (“Three Pillar”) with small banks provide stability and to low costs for customers (=low profitability of banks)

The problem is not that banks were safed, but that the managers were not held responsible for their mistakes

- Share holders made huge losses
- Instead of increasing capital requirements to prohibitive levels, change the compensation of bank managers (Dudley Proposal)
- Responsible divers are better than more and speed limits

Why we need strong banks